

Realty Stock Review

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MARKET STRATEGY: WE STILL SMELL CHEAPER MONEY AHEAD AND POSITION ACCORDINGLY

Cheaper money still lies ahead, in our opinion, but the current stalling in the market points to a conclusion that the big declines in short-term rates may have been seen already. With Treasury bills at about 7.25% currently, short rates are about 3.5% below a year ago, when we first spotted lower rates.

However long-term rates still have not moved down that much and with long-governments at about 10.4% and mortgages 12% or so, there seems to be a lot of room for improvement in long rates. We doubt inflation is a threat.

Real estate stocks rose 0.7% the past three weeks since our last issue, v. a 0.3% advance for the Dow-Jones Industrials. Realty stocks are up 9.3% so far as we approach mid-year, vs. an 8.4% gain in the DJI. This seems to take some of the steam out of the argument that realty stocks will be clobbered by the proposed tax law changes. We doubt we'll see any changes this year and the 1986 elections start to cloud the outlook once the calendar turns. Best performing groups this year are those least expected: Realty services and syndicators, up 24.6%; and mortgage bankers/finance, up 23.5%.

RANKING REVIEWS: SIX INVESTMENT BUILDERS AND DIVERSIFIED COMPANIES

We are reviewing Ranks for six investment builders, diversified and financial companies. Rankings are normally reviewed annually when longer term earnings and dividend trends are clear.

Kaufman & Broad Inc. (\$16.25--NYSE) holds B Rank with an 82% EPS gain to \$2.47/sh. in the Nov. 1984 year. Feb. qtr. EPS of 23¢ before extraordinary item was down 4%; the Feb. qtr. also included 25¢ taxloss carryforward benefits. Operations: KB is about half life insurance, half housing. Life insurance is growing with Jan. 31 acquisition of Capitol Life Insurance Co., boosting total insurance assets in the Sun Life Group to \$1.5 bil. Insurance contributed 42% of operating income in 1984 but the percentage rose to 93% in the Feb. qtr. because of weak manufactured housing results. Insurance operating results rose 39% in Feb. before impact of several special items, including sale of a home service marketing division, a charge to switch to more conservative accounting for deferred policy acquisition costs, and lower realized investment gains. Housing is divided between on-site homebuilding, which is extremely strong now, and off-site manufactured housing which is very weak. KB deli-

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vered 2,280 units in 1984, up 5%, with 78% of revenues from the U.S. (all Calif.), 17% France and western Europe, and 5% Canada. U.S. sales rose 21% to \$189 mil. in 1984. Canada sales rose but France fell 15%; KB acquired a French homebuilder in the Feb. qtr. to make it the third largest French builder. On-site sales rose 32% in dollars and 5% in unit deliveries in the Feb. qtr. but new orders leaped 74% and year-to-year backlog jumped 72%; a record year is predicted. In contrast manufactured housing suffered a \$3.9 mil. operating loss including \$2 mil. plant closing charge; unit deliveries fell 21%. Finances: KB has \$238 mil. outstanding over \$81.5 mil. convertible preferred and \$176 mil. common equity. Debt is 0.9 times total equity and 1.4 times common. Net book value is \$15.81/sh. Outlook: KB sells at about 5 times latest 12 mon. EPS, reflecting uncertainty over manufactured housing and generally lower life insurance multiples. Lower interest rates should benefit its two main segments.

Federal Natl. Mortgage Association or **Fannie Mae** (\$19.25--NYSE) holds C Rank mainly because EPS continue to be buffeted by interest rate swings. FNM lost 87¢ sh. in 1984, vs. \$1.13/sh. income diluted in 1983. The Mar. qtr. loss was 26¢ but the leverage inherent in FNM is so great that it may wind up in the black for 1985. A 16¢ dividend continues. Operations: FNM is a privately owned company that provides a secondary market in government-insured & conventional mortgages. It is considered a government agency for debt issuing purposes and has an ultimate back-up call on U.S. Treasury borrowings if needed. This structure lets it borrow heavily in capital markets (\$86.3 bil. debt at Mar. 31 is 72.6 times equity, easily the highest leverage ratio among

RSR companies). FNM held \$88.35 bil. net mortgages at Mar. end, divided 93.6% home mortgages and 6.4% apartment project mortgages. Home mortgages are 31.3% fixed-rate government insured, 44.9% fixed-rate conventional, 14.3% adjustable rate, and 3.2% seconds. Investor focus is on the slow rise of adjustables (or ARMs), since this removes risk from FNM by letting it lock in a spread over cost of borrowed funds. FNM bought \$5.8 bil. new loans in the first qtr., up 33%, helping build a higher yielding, better matched portfolio to offset the drag of older, fixed rate loans (which FNM calls its "block of granite"). ARMs were 31% of new purchases. This let FNM cut its negative interest spread (return on mortgages less debt interest) to \$46.6 mil., down 59% in dollars; negative spread of 0.52% compared to negative 0.74% the previous quarter. Financing: FNM has \$14 bil. of debentures with average cost of 11.9% coming up for refinancing the next three qtrs. With FNM issues now selling in the low 7% range, major interest savings may be at hand. About 36% of debt comes due in one year and all debt has a 2.75 year average life. Outlook: Because of its high leverage, FNM stock is very volatile depending on interest rate perceptions, the main determinant of EPS. Loan losses also affect EPS and FNM provided \$23.5 mil. for losses in the Mar. qtr., up 52%. Actual loan chargeoffs rose 13% to \$19.4 mil. Book value is \$18.05/sh. at March; FNM sold 7 mil. new shs. Apr. 30 at \$15.875.

Integrated Resources Inc. (\$19.75--NYSE) holds C Rank. EPS fell 18% to \$2.70 diluted in 1984, ending a four-year uptrend. The Mar. qtr. lost 74¢ sh. after preferred dividends. No common dividend is paid but three preferreds (two convertible, one adjustable) all trade on the NYSE. Operations: The largest sponsor and seller of syndication and annuity programs in the U.S., IRE raised \$1.035 bil. equity for its programs last year, a record and up 30% from 1983. Of this 84% or \$866 mil. went into real estate, and the rest was oil and gas, equipment leasing, cable TV, etc. A full 49% of real estate

NOTE TO SUBSCRIBERS: We begin this issue to expand our Ranking Reviews to meet the request of many subscribers for more basic research input. Quarterly group reviews are discontinued to make room for this expanded research, which comes in a new four-page format.

funds went into privately offered programs (generally to higher income investors) while 35% went into publicly offered real estate programs. IRE made its initial mark with commercial net leased property programs (generally with high tax shelter writeoffs) but these fell 44% to \$199 mil. in 1984, mainly because of uncertainties over, first, the 1984 Deficit Reduction Act and, now, the pending tax change proposals. IRE has filled this gap with income oriented commercial real estate programs and a new mortgage program, American Insured Mortgage Investors or AIM, which generated \$199 mil. sales. REIT shares, in its Resources Pension Shares, added \$62 mil. Marketing uncertainties tended to narrow margins on the new lines and operating income from investment programs fell 6% to \$59 mil. IRE's unconsolidated insurance operations balanced this with a 13% gain to \$17 mil. Interest on investor receivables and deferred fee and contract rights income fell 15% to \$16 mil., and total operating income was off 5% to \$92.5 mil. After-tax income at \$58.8 mil. was up 2% but a 42% jump in preferred dividends to \$40.6 mil. cut final EPS to \$2.70/sh. Finances: IRE is leveraged with \$239 mil. corporate debt and \$341 mil. preferred over \$109 mil. common equity. Corporate debt is 0.5 times all equity but if \$175.2 mil. non-convertible and redeemable preferred is treated as debt, \$415 mil. total debt and preferred is 1.4 times the resulting equity. IRE also has borrowed \$240 mil. against \$320 mil. of notes from investors electing to pay for their programs over several years. Although some concern has been expressed over IRE's leverage, liquidity appears good as it holds \$201 mil. cash and marketable securities. Outlook: IRE has begun a major ad campaign to stress its presence among major financial service companies. Product offering emphasis has shifted from smaller programs to ones believed possible of selling large dollar volumes over several years. IRE also has substantial residual interests in properties financed over the years. Tax law changes have been a constant threat over the years, and IRE has generally rolled with changes. These risks and leverage make common volatile. The

\$3.03 preferred (convertible at \$27) and \$4.25 preferred (convertible at \$47.25) are more conservative. Common book value net of preferred is \$17.41/sh.

Del E. Webb Corp. (21--NYSE) rises to B Rank on improving EPS and finances. WBB earned \$1.61 sh. from normal operations in 1984, up 109%. Management projects a 20% rise in 1985 to about \$2/sh., depending upon completion of several land sales. The common pays a 20¢ dividend. Operations: WBB has left the hotel/casino ownership business, paring long-term debt in half. WBB still operates four casino/hotels for a fee but is now focused on residential and commercial property development, property management, and scaled back construction services and contracting. Community development, mainly WBB's housing and commercial development at Sun City West northwest of Phoenix generated only 28% of revenues but 98% of operating profits in 1984. WBB delivered 951 homes in 1984 and operating profit from home sales nearly quadrupled to \$16 mil. WBB continues developing homes in 5,700-acre Phase I of Sun City West, while making bulk land sales in Phase II. Approx. 1,200 acres were sold in 1984 for \$23 mil. operating profit, up 83%, and another 1,750 acres are under sale agreement for closing the next 18 months. Development's \$39.5 mil. operating profit rose 140%. Operating profit from buying, developing and selling commercial property doubled to \$2.2 mil. WBB's Nevada casino/hotels had \$6.6 mil. operating losses offset by \$7.1 mil. income from contract hotel management and \$4.8 mil. recreational properties, mainly from expansion at Wahweap Lodge and Marina on Lake Powell. General construction revenues rose 23% but the unit lost \$6.6 mil., mainly due to several jobs in Dallas. Finances: Long-term debt and redeemable preferred of \$110 mil. is 0.96 times equity of \$14.61/sh. There is no short-term debt. Liquidity is up and WBB holds \$42 mil. cash and short-term investments; current assets are 1.1 times liabilities, WBB's best ratio in years. Outlook: WBB has filed to offer 2 mil. new shs. of a proposed REIT, Del E. Webb Investment Properties, to be managed by the compa-

ny. With EPS more dependent upon land and housing sales, interest rate trends will influence results.

Koger Co. (\$29.25--ASE) holds A Rank with a strong CFS gain. KGR net cash flow, as computed by Audit, was \$1.53/sh., up 20%. KGR reports an additional 67¢ sh. net cash flow, including additional interest and discount on its real estate appreciation notes and deferred income taxes. The dividend was raised 5.5% recently to \$2.32 rate; all was taxfree return of capital in the past three years. Net CFS has risen at 13% annually over KGR's four years as a public company. Operations: KGR owns 148 suburban office buildings in 12 Sunbelt cities (Jacksonville, Orlando, El Paso, San Antonio, St. Petersburg, Atlanta, Tallahassee, Charlotte, Austin, Tulsa, Greenville, and Greensboro) with 3.92 mil. rentable sq. ft. Space was 97% leased at Dec. 31, 1984 at average effective rates from \$9.25 to \$12.80/SF. Asking rents for new tenants range from 4% to 28% over the average except in Tulsa, where continued energy-related weaknesses hurt. Finances & Current Value: KGR has \$77.2 mil. mortgages and \$40 mil. real estate appreciation notes (property appreciation is paid as additional interest) over \$9 mil. historic cost net equity and \$185 mil. current value equity. Current net asset value, after debt discounts and deferred expenses, is \$23.56/sh. Outlook: KGR's centers have competed effectively with the recent surge of speculative Sunbelt office building, mainly because by controlling building costs tightly KGR can make money at competitive to below-market rents. Lower interest rates would help. KGR has agreed to buy an additional \$212 mil. properties developed by its affiliated Koger Properties thru Dec. 1989.

Rouse Co. (\$23.00--OTC) holds A Rank with continued strong net cash flow gains. CFS rose 37% to 79¢ sh. after the recent 2-for-1 split; CFS has risen at 29.8% over the past five years. EPS under generally accepted accounting was 23.5¢ sh. plus a \$1.04 sh. gain on sale of its mortgage banking subsidiary. The dividend was raised 17% to a 54¢ rate.

Operations: As the premier shopping center developer in the U.S., ROUS owns or manages 59 shopping centers with about 37 mil. sq. ft. Shopping center revenues, mainly base and percentage rents, rose 15% to \$182.6 mil. in 1984, in line with the 15.8% annual growth rate the past five years. Operating expenses and interest rose 16%, so net contribution was squeezed slightly, and operating profits rose only 10%. Part of the drag is attributed to start-up costs at new centers; profits have risen at 18.6% the past three years excluding start-up losses. A big start-up drag appears to be at New York City's South Street Seaport, where a high-rate construction loan that cannot be rolled into permanent financing till this July hurts results. ROUS opened five new projects in 1984, including first phase of National Place Shops in Washington; Tabor Center in Denver; and Federal Financial Center in downtown Baltimore. Three projects are set for 1985 openings, including 125,000 SF in the second phase of South Street Seaport; another 60,000 SF at National Place Shops; and 160,000 SF at St. Louis' Union Station. Three other projects are on target for 1986 opening, including Owings Mills with 325,000 SF in suburban Baltimore; Riverwalk in New Orleans with 185,000 SF; and an 125,000 SF expansion of North Star Mall in San Antonio. Even though ROUS has emphasized urban centers in recent years, it has carved out a long lead in such developments, being trailed by Forest City Enterprises. Such projects, once completed, tend to have staying power and value. Finances and Current Value: ROUS' hallmark is conventional mortgage leverage with \$418 mil. property debt 4.8 times historic equity. ROUS however pioneered the appraisal of its properties for public investors and reports current value equity of \$731 mil., or debt only 0.6 times current value equity. Current value equity works out to \$23.88/sh. Outlook: ROUS has just agreed to pay \$120 mil. for the new town of Columbia south of Baltimore, which ROUS initiated and has developed for Cigna Insurance. This should add a new dimension to growth, since this now-established community likely contains less risk.